MCCARTHY GRITTINGER
FINANCIAL GROUP LLC

Diversification for Uncertain Times

Dear Valued Clients & Friends:

"*It's not supposed to be easy. Anyone who finds it easy is stupid*."
- Charlie Munger, Vice Chairman of Berkshire Hathaway

"*Diversification is your buddy*"
- Merton Miller, Nobel laureate in economics

Market Risk

It is always an interesting time to be an investor. As we have discussed previously, people reading the investment news every day without the knowledge of some simple investment principles would be very overwhelmed. The investment jargon, fancy charts, and emotional wording can cause an investor's blood pressure to rise quickly. It is fascinating to read about today's investment world being especially "volatile", "uncertain", "risky", and "unpredictable". In our opinion, these words could describe markets every day. Some days that volatility shows up and sometimes it does not. Whether or not volatility is seen on a daily basis, does not mean that the potential has gone away. Howard Marks, a well-known investor, describes risk as the potential for more things happening than will happen.

With equity markets continuing their upward path during the first quarter and first few weeks of April, we are frequently asked if now is the right time to be in the stock market (is now the right time to invest cash, should I reduce my equity allocation, etc.). Our simple but difficult answer is to bring the discussion back to the specific client's established target asset allocation and goals. I recently came across another Howard Marks quote that highlights both sides of the sell discussion. Marks wrote in his September 9, 2015 memo for Oaktree Capital:

> *"Two of the main reasons people sell stocks are because they go up and because they go down. When they go up, people who hold them become afraid that if they don't sell, they'll give back their profit, kick themselves, and be second-guessed by their bosses and clients. And when they go down, they worry that they'll fall further."*

This quote is very enlightening for investors trying to understand personal biases and the role emotions play on investor thinking. Knowing the very low probability of being able to predict the exact highs and lows of the market, investors are forced to arrive at a decision in some way. A rules-based asset allocation approach can help investors act in a prudent way while dealing with the emotions and everyday uncertainty. That is why we bring clients back to original asset allocation discussion and goals.

Last November, we discussed some simple investment beliefs that are helpful in developing an investment plan. This month we are going to highlight smart diversification.

Diversification is defined in the dictionary as "*an act of investing in a variety of securities so that a failure or an economic slump affecting one of them will not be disastrous*".

Academic finance is filled with research preaching the benefits of diversification. To be practical, and without getting too technical, diversification is an attempt to achieve high returns with the lowest amount of risk.

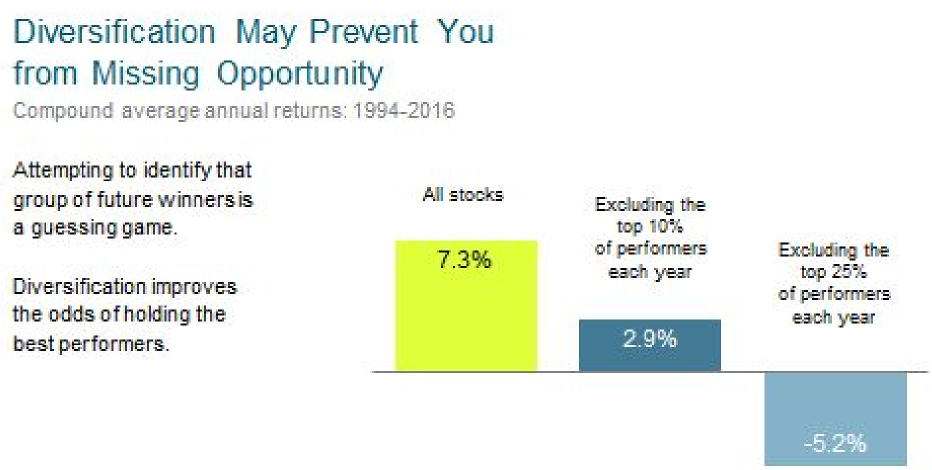
With diversification, investors must also be aware of what they are giving up. First off, it means that not all investments are going to move in the same direction all the time. A quick example helps highlight the difference.

> Assume investor A only invests in one company. Investor A's return is going to be entirely dependent on that one company's return. Investor A will be very concerned and very watchful of that one stock given the entire portfolio return is determined with that one stock.
>
> Now assume investor B invests in thousands of companies across many different industries. Investor B is going to have many different individual company returns. However, investor B has much less concern about the individual company returns since the effect of one company most likely will not be material.

This simplified example can be a powerful reminder of a few different principles. The first being the more concentrated you are, the more you are reliant on that concentrated strategy (i.e. company, industry, and country concentration) to outperform.

The second is how you are going to feel emotionally watching and comparing performance. Watching a concentrated strategy underperform can lead to investment doubt which can cause an investor to change investment plan and strategy at possibly the wrong moment. The flipside can also occur. Diversified investors can watch certain concentrated strategies outperform their diversified approach which can cause them to think they are missing out.

Investors must understand their investment strategy so they can stick to the strategy. Investors can have the best idea, but if you do not understand it and abandon it at the first sign of trouble, the plan will not work. Diversification by its definition means not every investment will outperform the market. However, that also means that properly diversified investors should own some investments that are outperforming the market. To illustrate this last point, here is a chart comparing returns for all stocks vs returns excluding the top 10% and top 25% of performers each year.



The "All stocks" portfolio consists of all eligible stocks in all eligible Developed and Emerging Markets. The portfolio for January to December of year t includes stocks whose free float market capitalization as of December t-1 is greater than $10mln in developed markets and $50mln in emerging markets and with non-missing price returns for December of year t-1. Annual portfolio returns are value-weighted averages of the annual returns on the included securities. The portfolios "Excluding the top 10%" and "Excluding the top 25%" are constructed similarly. Individual security data are obtained from Bloomberg, London Share Price Database, and Centre for Research in Finance. The eligible countries are: Australia, Austria, Belgium, Brazil, Canada, Chile, China, Colombia, Czech Republic, Denmark, Egypt, Finland, France, Germany, Greece, Hong Kong, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Republic of Korea, Malaysia, Mexico, Netherlands, New Zealand, Norway, Peru, Philippines, Poland, Portugal, Russia, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Kingdom, and the United States. Diversification does not eliminate the risk of market loss. Past performance is no guarantee of future results.

Summary

Market risk will always be present no matter whether it can currently be seen or not. There is power in knowing that truth in order to stick with your own individualized investment and financial plan. Diversification is a tool that helps investors deal with that market risk.

We hope everyone is enjoying the beginning of spring season. For those in the Midwest, it is powerful to see the green grass and flowers begin to bloom again. Please do not hesitate to reach out to us if there is something you would like to discuss between normal meeting times.

Finally, for those that are interested, we have again posted on our website a more in-depth review of the first quarter stock and bond markets. This is a great resource showing specific market performance. To read that review, click *here*.

We appreciate your business and look forward to talking with you soon.

Matt Miler, CPA, CFP®